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No. 983

IN THE

Supreme Court of the United States

OCTOBER TERM, 1963

CHICAGO NORTH SHORE AND MILWAUKEE RAILWAY COMPANY, *Petitioner,*

v.

UNITED STATES OF AMERICA, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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IN THE

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CHICAGO NORTH SHORE AND MILWAUKEE RAILWAY COMPANY, *Petitioner,*

v.

UNITED STATES OF AMERICA, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Chicago North Shore and Milwaukee Railway Company petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in the above cause.

OPINIONS BELOW

The unreported opinion of the United States District Court for the Northern District of Illinois, Eastern Division, is set forth at page 2 of the Appendix to Appellants Brief (in the Court of Appeals) filed herewith.

The opinion of the Court of Appeals, 326 F. 2d 860, is set forth at the close of this petition.

JURISDICTION

The judgment sought to be reviewed is dated and was entered January 16, 1964. The jurisdiction of this Court is invoked under sections 1254(1) and 2101(c) of Title 28, U.S.C.

QUESTIONS PRESENTED

1. In 1944 the holders of taxpayer's defaulted promissory notes sold the taxpayer's coupon bonds which they held as collateral security for said notes. The parties to this suit stipulated that "the amount of interest on the collateral bonds sold in 1944 . . . computed from January 1, 1944 to the respective dates of sale thereof . . . amounted to $81,393.82." The trial court adopted the stipulated facts as its findings of fact.

The question presented is whether an accrual basis taxpayer may deduct the aforesaid interest which accrued unconditionally in 1944 or whether as held by the courts below the amount of said interest constitutes bond discount and must be amortized.

2. In 1932 the taxpayer deposited its own mortgage bonds as collateral security for the payment of four promissory notes issued by it in 1932 to Reconstruction Finance Corporation and three Chicago banks. Semi-annual interest coupons maturing subsequent to June 30, 1932, were attached to the bonds. After default on the notes, the bonds were sold in 1944. Upon the sale, matured interest coupons in the amount of $2,295,205.07 became due and payable forthwith. This figure is the aggregate of the obligation evidenced by interest coupons maturing prior to January 1, 1944, in the amount of $2,213,811.25 and interest from January 1, 1944 to

the respective dates of the bond sales in 1944 in the amount of $81,393.82.

The question presented is whether under the accrual basis of accounting the $2,295,205.07 obligation is deductible in 1944 when it became due and payable unconditionally, or whether, as held by the courts below, such amount must be amortized and deducted ratably over the period intervening to the date in 1956 upon which the principal amount of part of the bonds became due according to their original tenor.

3. Subsequent to the sale of the collateral bonds in 1944, and for the year 1945 and the ten months period ending October 31, 1946, the taxpayer deducted interest accrued upon its three remaining outstanding promissory notes. The claims of the holders of these notes were subordinated in a Chapter X Bankruptcy proceeding and there was little likelihood that the notes or the interest thereon would be paid.

The question presented is whether an accrual basis taxpayer may deduct the interest which accrued on the notes subsequent to the sale of the collateral security for the notes.

4. Pursuant to a Chapter X Bankruptcy reorganization a new corporation was formed and on November 1, 1946, all of the old debtor corporation's assets, including the real property which constituted the security for the old corporation's bonded indebtedness, were transferred to the new corporation. The new corporation assumed the obligation to pay any income tax liability of the old corporation and it assumed the obligation to satisfy the old mortgage bond obligation by the payment of cash and the issuance of its own capital stock. It assumed no other obligations or debts of the

old corporation. The old corporation was liquidated and dissolved.

The question presented is whether upon the transfer of the mortgage property to the new corporation in 1946 and the complete liquidation and dissolution of the old corporation, the latter may deduct its unamortized bond discount.

5. In 1932 the taxpayer deposited its own coupon bonds as security for the payment of its four promissory notes. In 1944 after default on the notes, the noteholders sold the collateral bonds. The principal obligation of the bonds, together with the obligation evidence by matured interest coupons exceeded their proceeds by $4,185,029.07.

The question presented is whether the $4,185,029.07 may be deducted as a cost or an expense or a loss when it accrued unconditionally in 1944, or whether, as held by the courts below, this amount must be treated as bond discount and amortized and deducted ratably over the period intervening to the dates in ~~1955 and~~ 1956 upon which the principal amount of the bonds became due according to their original tenor.

STATUTORY PROVISIONS

INTERNAL REVENUE CODE OF 1939, TITLE 26, U.S.C.

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or Business Expenses.—

(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade

or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

* * * * * * *

(b) Interest.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

* * * * * * *

(f) Losses by Corporations.—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise."

STATEMENT

This is a suit for refund of income taxes for the year 1945. Because of a loss carrover from 1944 and a loss carryback from 1946, those two years also are involved. No question as to the right to such carryover or carryback is raised, the only question with respect thereto being the amounts thereof.

The taxpayer's accounts were kept, and its tax returns were filed on the accrual basis.

In 1932, in the normal course of a funding operation, the taxpayer issued its four promissory notes, due April 1, 1935, to Reconstruction Finance Corporation and three Chicago banks. It deposited its own mortgage bonds, with all semi-annual interest coupons dated subsequent to June 30, 1932, attached, as collateral security for the promissory notes. One bank assigned its note to the Reconstruction Finance Corporation,

together with the collateral security deposited in connection therewith.

Subsequently, in 1932, a receivership proceeding was commenced in the United States District Court at Chicago, other proceedings were filed and in 1942 all prior proceedings were consolidated into a Chapter X Bankruptcy proceeding filed in 1942. The four promissory notes were not paid when due and remained in default. Pursuant to authority granted by the Court, the Reconstruction Finance Corporation and one other noteholder, at various times in 1944, sold the collateral bonds held as security. The remaining noteholder sold part of its collateral and took title to the balance in payment of the remaining note liability owed to it.

The bonds contained a provision accelerating their maturity upon the occurrence of certain events of default. When the bonds were sold the events of default had occurred and, accordingly, the bonds were due and payable when they were sold by the note holders.

In its income tax return for the year 1944, the taxpayer deducted the net result of the foregoing transactions as a loss, resulting in a net operating loss carryover to the year 1945.

In 1946, pursuant to a plan of reorganization, a new corporation was formed and on November 1, 1946, all of the old corporation's assets, including the real property which constituted the security for the mortgage bonds, were transferred to the new corporation and the old corporation was dissolved. The new corporation agreed to pay any federal income taxes that might be due from the old corporation, and it satisfied the old corporation's bonded indebtedness by the payment

of cash and the issuance of its own capital stock to the bondholders.

The Commissioner of Internal Revenue disallowed a portion of the 1944 loss claimed upon the old corporation's return (thus reducing the 1944 loss carryover) and assessed a deficiency in tax for the year 1945 against the new corporation as *transferee*. The latter paid the tax and interest thereon, duly filed a claim for refund which was denied, and brought suit for refund as provided by Sections 1346 of Title 28 and 7422, Title 26, U.S.C. The trial court adopted the stipulation of facts as its findings of fact and entered judgment for the defendant. The Court of Appeals affirmed.

The trial court's opinion and judgment and the stipulation of facts are set forth in the printed Appellant's Appendix filed in the Court of Appeals, a copy of which is attached hereto.

REASONS FOR GRANTING THE WRIT

I.

The Court of Appeals Decision, Denying a Deduction of $81,392.82 as Interest for the Year 1944 is in Conflict With a Decision of This Court and With Decisions of the Third and Ninth Circuits.

The court's ruling with respect to an item of $81,393.82 is in conflict with a decision of the Supreme Court and several Court of Appeals decisions.

On page 9a of its opinion the Court of Appeals held that "the $2,295,205.07 which the Railway seeks to deduct as interest is not interest *in fact*." This determination was made notwithstanding that the parties stipulated that $81,392.82 thereof was interest (pars. 14 and 15, Stipulation of Facts, C.C.A. Appen-

dix 28-29), and the trial court adopted the stipulated facts as its finding of facts. The $2,295,205.07 consisted in part of $2,213,811.25 evidenced by collateral bond interest coupons maturing *prior* to January 1, 1944. The remaining $81,392.82 represented "interest computed from January 1, 1944 to the respective dates of sale thereof . . ." in 1944.

In disallowing the entire amount as a current deduction, the courts below disallowed the $81,393.82 interest included therein which accrued for that portion of the year 1944 prior to the sale of the collateral bonds. The Court of Appeals held (opinion p. 9a) that inasmuch as there was no indebtedness on the collateral bonds prior to their sale, no interest with respect thereto could be accrued and deducted for any period prior to such sale.

The same reasoning and conclusion were rejected in the following cases, and the decision of the Court of Appeals in the present case is in conflict therewith.

Commissioner v. *Philadelphia Transportation Company*, (1949), 338 U.S. 883, 70 S. Ct. 186, affirming per curiam, 3 Cir., 174 F. 2d 255 and 9 T.C. 1018.

Pressed Steel Car Co., Inc. v. *Commissioner*, 3 T.C.M. 868, 876-877, aff'd. per curiam, 3 Cir. 1945, 152 F. 2d 280, cert. den. 328 U.S. 838, 66 S. Ct. 1013.

Commissioner v. *Columbia River Paper Mills*, 9 Cir. 1942, 126 F. 2d 1009.

See also, *Oregon Pulp & Paper Co.* v. *Commissioner*, 1942, 47 B.T.A. 772, 779, appeal by Commissioner dismissed, 9 Cir. Nov. 2, 1943.

The Court of Appeals, in holding that there can be no interest deduction allowed with respect to any period

prior to the dates the bonds were sold, applied the rule of *Commissioner* v. *Drovers Journal Publishing Co.*, 7 Cir. 1943, 135 F. 2d 276, 279 but without citing the latter case. The latter was in conflict with *Commissioner* v. *Columbia River Paper Mills, supra*, a Ninth Circuit case decided in 1942. It was also in conflict with *Pressed Steel Car Co.* v. *Commissioner, supra*, a Third Circuit case decided in 1945. The denial of certiorari in the latter case failed to resolve the conflict. By granting certiorari and affirming the Third Circuit in 1949 in *Philadelphia Transportation Co.*, the Supreme Court resolved the conflict *against* the rule of the Seventh Circuit in *Drover's Journal Publishing Co.* Nevertheless, in the present case the Court of Appeals follows the basic reasoning and result of its own Circuit in the *Drovers Journal* case and ignores *Philadelphia Transportation Co.* and the other conflicting Court of Appeals decisions cited above.

In the *Philadelphia Transportation* case, *supra*, the courts allowed, in the year of issuance of the bonds, a deduction for accrued interest in an amount equal to the aggregate of all matured interest coupons attached at the date of sale. In that case when the bonds were sold there were attached thereto coupons which matured not only in the taxable year of sale but also in the prior taxable year. Similar treatment in the instant case would allow an interest deduction in 1944 in an amount not less than the $81,393.82 interest item which was stipulated to be interest, and would also allow an interest deduction for the year 1944 of approximately $189,119 evidenced by the 1943 interest coupons which accrued unconditionally upon the sale of the bonds in 1944.

The treatment accorded this taxpayer is in conflict with each of the cases cited above. It is also in conflict with the "all events" test reaffirmed in *United States* v. *Consolidated Edison Co.*, 1961, 366 U.S. 380, 384, 81 S. Ct. 1326, 1329. That case requires an accrual basis taxpayer to take deductions in the year, and only in the year, in which the obligation unconditionally accrues.

The Court of Appeals avoided any reference in its opinion to the $81,393.82 interest item which was emphasized on brief and oral argument. The fact that the item was ignored by the Courts below, ought not serve as a cloak to avoid the granting of the Writ.

II.

The Holding of the Court Below That An Item of $2,295,205.07 Must be Treated as Bond Discount and Amortized Over a Period Beyond Its Due Date to the Maturity of the Principal Amount of the Bonds is in Conflict With Applicable Decisions of This Court.

The Court of Appeals held that the $2,295,205.07 evidenced by the prior dated interest coupons which accrued unconditionally upon the sale of the bonds in 1944 was bond discount and should be amortized ratably over the intervening period to April 1, 1956, the date upon which the principal amount of part of the collateral bonds, namely the Series B and C bonds, became due according to their original tenor. (Opinion p. 40a, and C.C.A. Appendix p. 4)

Bond discount is the excess of the principal amount of the debt *which is to be paid at the maturity of the bonds* over the proceeds received from the lender at the time of the creation of the debt.

New York C. & S. & L. R. Co., 1931, 23 B.T.A. 177, 196.

Helvering v. *Union Pacific R. Co.*, 1934, 293 U.S. 282, 284, 286, 55. S. Ct. 165, 166, 167, 168.

Dodge Brothers v. *United States*, 4 Cir. 1941, 118 F. 2d 95, 103.

Pierce Oil Corp. v. *Commissioner*, 1935, 32 B.T.A. 403, 420, 421.

The $2,295,205.07 involved in this issue does not fall within the definition of bond discount. It is *not* an amount which is to be paid at the maturity of the bonds in 1955 and 1956. In *Helvering* v. *Union Pacific R. Co., supra*, the court said (pp. 284 and 166):

> "It follows that when the return is made on the accrual basis, expenses or obligations incurred by the taxpayer in connection with a bond issue, *which are not discharged until payment of the bonds at maturity*, may properly be accrued or amortized over the period of the life of the bonds * * *." (Italics added).

And at pages 277 and 168, the Court refers to "the difference between the net amount of capital realized upon issue and the par value of the bonds" which must be paid to the bondholders at a fixed date, namely, the due date of the bonds. The court held that the commissions there in issue were, in substance, the same as bond discount because, and only because, like bond discount, they reduced the proceeds to the borrower and were to be paid at the *maturity of the principal amount of the bonds.*

For illustration, according to their original tenor, the Series A bonds herein involved matured January 1, 1955, and the Series B and C bonds matured April 1, 1956. Could the Court of Appeals, by judicial fiat, declare that any bond discount attributable to the

Series A bonds must be amortized, not to their own maturity date, but to April 1, 1956, the maturity date of the Series B and C obligations? Yet that is precisely what it did with respect to the $2,295,205.07 obligation when it required that this amount be amortized to April 1, 1956.

Bond discount is an amount which is due and payable at the maturity date of the face amount of the bonds. Such maturity date marks the end of the intervening period over which the discount must be prorated. The $2,295,205.07 obligation here in issue accrued unconditionally in 1944. It matured and became due and payable forthwith upon the sale of the collateral bonds in 1944. That date marked the end of any possible amortization period with respect to any bond discount feature attributable to the $2,295,205.07 obligation. There is no future maturity or due date to which it can be amortized. *There is no statutory provision, no regulation, and so far as we are aware no court decision, other than the present one, which requires the amortization of bond discount beyond the date when such discount obligation matures and becomes due and payable.*

The $2,295,205.07 in issue cannot be classified as bond discount, and, regardless of its classification, there is no authority for its amortization over a period subsequent to its due date.

The bond discount rule is an exception to the general rule of income tax accrual. The general rule, reaffirmed by this Court in *United States* v. *Consolidated Edison Co.*, 1961, 366 U.S. 380, 384-385, 81 S. Ct. 1326, 1329, requires that an item which accrues unconditionally must be deducted in the year of accrual and in no other year.

The decision of the court below is in conflict with *Helvering* v. *Union Pacific R. Co.*, *supra*, in that (1) it requires amortization as bond discount of an amount which is not bond discount, and (2) it requires amortization of such amount beyond its maturity or due date to a future date when it is neither due or payable.

The decision is also in conflict with *United States* v. *Consolidated Edison Co.*, *supra*, in that it fails to allow the deduction in the year when it accrued unconditionally.

III.

The Holding of the Trial Court Affirmed by the Court of Appeals Disallowing Deduction of Interest Accrued on the Taxpayer's Outstanding Promissory Notes is in Conflict With Decisions of Two Other Circuits.

When the collateral bonds were sold in 1944 one of the collateral notes was satisfied and the other three notes continued as outstanding obligations. The taxpayer deducted the interest accrued on these three notes for the years 1944, 1945 and the 10 months period ending November 1, 1946. In determining the deficiency here in issue, the Commissioner allowed the deductions. As an affirmative defense, although not pleaded, the Government contended that no interest was accruable or deductible on such notes subsequent to the sale of the collateral. The District Court held that such interest should be disallowed as a deduction "there being no fixed and definite obligation to pay interest thereon after the sale of the bonds in 1944" (C.C.A. Appendix p. 5).

The Court of Appeals did not refer to this issue in its opinion, but in affirming the District Court it sanctioned that Court's holding.

The holding is in direct conflict with the decisions in the following cases:

Fahs v. *Martin*, 5 Cir. 1955, 224 F. ed. 387, 392-393, 395;

Zimmerman Steel Co. v. *Commissioner*, 8 Cir., 1942, 130 F. 2d 1011, 1012;

Keebey's Inc. v. *Paschal*, 8 Cir., 1951, 188 F. 2d 113, 115. See also I. T. 3635, 1944 C.B. p. 101.

This issue involves an important question of federal income tax law, namely, whether an accrual basis taxpayer may be deprived of deductions which unconditionally accrue merely because, due to his financial condition or due to his involvement in Bankruptcy or receivership proceedings, there is a likelihood that such accrued obligation will not be paid. In other words, must a financially embarrassed accrual basis taxpayer be denied deductions to which he would otherwise lawfully be entitled. This is a question of exceedingly broad and important impact which should be decided by this Court.

Nor should the foregoing conflict of Circuits remain unresolved.

* * * * * * *

Subsequent to the time the foregoing was written this Court on March 23, 1964, decided *Bruning* v. *United States*, No. 423, U.S. . The opinion, together with note 4 thereof, states (1) that the filing of a petition in bankruptcy does not prevent the running of interest during the bankruptcy proceeding, and (2) that the rule denying post petition interest as a claim against the bankruptcy estate is applied "not because the claims had lost their interest bearing quality during that period, but as a necessary and enforced rule of distribution * * *".

The decision of the trial court in the present case that there was "no fixed and definite legal obligation to pay interest thereon after the sale of the (collateral) bonds in 1944" (C.C.A. Appendix p. 5), which holding was affirmed by the Court of Appeals, is in conflict with *Bruning* v. *United States, supra*, and the cases cited in note 4 of that opinion, as well as the Fifth and Eighth Circuit cases cited above.

IV.

The Court's Holding That, Upon the Transfer of the Mortgaged Property and the Complete Liquidation and Dissolution of the Taxpayer, It Could Not Deduct Its Unamortized Bond Discount is in Conflict With Decisions of This Court and of a Court of Appeals.

On November 1, 1946, the actual effective date of the plan of reorganization under Chapter X of the Bankruptcy Act, the taxpayer transferred to a new corporation all of the property and assets of the old corporation, in consideration of the assumption by the new corporation of certain liabilities of the old corporation including ". . . any claim of the United States against the Debtor for taxes . . ." and the bonded indebtedness of the old corporation. The old corporation was then dissolved. Included among the assets transferred was the real property which constituted the security for the taxpayer's mortgage bonds. The new corporation satisfied the bond obligation in full by the payment of cash and the issuance of its own common stock. The Court of Appeals held that the old corporation could not upon liquidation and dissolution deduct its unamortized bond discount because:

1. The new corporation was merely a continuation of the old corporation, and

2. Viewing the two corporations as separate entities, the new corporation may not take the deduction because the deduction is available only to the old corporation.*

(1) The new corporation did not become liable for all of the old corporation's liabilities. The two corporations had different shareholders and different corporate structures. They filed separate income tax returns. The tax liability of the old corporation was imposed against the new corporation as *transferee* because it had specifically *assumed* that liability.

As pointed out in *Donohue* v. *United States*, 1953, 112 F. Supp. 660, 663, the new corporation, following a railroad reorganization, is a different corporation and a different taxpayer from the old corporation and the "ruling of the Supreme Court in *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435" is controlling.

The old corporation and the new corporation were separate and distinct taxable entities.

New Colonial Ice Co. v. *Helvering*, 1934, 292 U.S. 435, 54 S. Ct. 788.

Standard Paving Co. v. *Commissioner*, 10 Cir. 1951, 190 F. 2d 330, cert. den. 342 U.S. 860, 72 S. Ct. 87.

Cf. *Moline Properties* v. *Commissioner*, 1943 319 U.S. 436, 63 S. Ct. 1132.

The holding of the Court below that the new corporation "is substantially the same as the old corporation" is in conflict with *New Colonial Ice Co.* v. *Helvering*, *supra*.

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* The court's reasoning (see pp. 11a-12a of opinion) is not clear. The court would appear to have forgotten that it was determining the tax liability of a *transferee*.

(2) Its holding is in conflict with *United States* v. *Memorial Corporation*; 6 Cir. 1957, 244 F. 2d 641, 644, which held that upon its liquidation and dissolution, the taxpayer was entitled to the deduction of its unamortized bond discount.

Its holding also is in conflict with the following decisions:

Longview Hilton Hotel Co. v. *Commissioner*, 1947, 9 T.C. 180, 182, "Acq." C.B. 1947-2 at p. 3, which held that upon liquidation and dissolution, the unamortized mortgage discount was deductible by the taxpayer;

S. & L. Building Corp. v. *Commissioner*, 1930, 19 B.T.A. 788, 795, Acq. C.B. X-1, p. 60, (cited in note 3 of Helvering v. Union Pacific R. Co., 293 U.S. 282) which held that where the mortgaged property was sold and the purchaser assumed the mortgage obligation, the unamortized mortgage discount was allowable as a deduction in the year of sale; and,

Metropolitan Properties Corp. v. *Commissioner*, 1931, 24 B.T.A. 220, 225, Government appeal dismissed 5 Cir. Feb. 21, 1933, Acq. CB XI-1, p. 5, which held that where the mortgaged property was sold subject to the mortgage, the unamortized bond discount should be allowed as a deduction.

In *Anover Realty Corp.* v. *Commissioner*, 1960, 33 T.C. 671, 674, the Tax Court held that upon transfer of the mortgaged property in dissolution, the unamortized mortgage discount deduction was not available to the transferee corporation but was available only to the transferor corporation.

The Court of Appeals cites *Anover Realty Corp.* v. *Commissioner*, *supra*, (see p. 12a of opinion) in support of its holding. Yet this case is wholly consistent

with the other decisions cited above and tends to support the taxpayer's position rather than that of the Government. The Court says that the theory of the taxpayer is "dichotomous," but the dichotomy is in the opinion of the Court of Appeals and is attributable to Court's failure to deal with the question in the light of the fact that the taxpayer is a *transferee*.

In the present case the mortgaged property was transferred to the new corporation free and clear of the mortgage lien, but the new corporation assumed the mortgage bond liability and discharged it in full by the payment of $3,500,000 cash and the issuance of its own capital stock.

By "acquiescing" in the foregoing Tax Court decisions and publishing such acceptance in the official Internal Revenue Cumulative Bulletins cited above, the Commissioner not only acknowledged the correctness of the rule therein stated but also eliminated any possibility of an appeal to a Court of Appeals.

We respectfully suggest that the conflict with *New Colonial Ice Co.* v. *Helvering*, *supra*, and the conflict of the present case with the *Memorial Corporation* case, *supra*; and with the cited Tax Court cases dating back over a period of 34 years, and which have been accepted as correct by the Commissioner, are of sufficient importance to warrant the attention of this Court.

V.

The Holding of the Courts Below That the Sale of the Collateral Bonds in 1944 Must Be Treated as a Separate Transaction is in Conflict With the Rule Followed By Several Circuits That An Integrated Transaction May Not Be Broken Down Into Its Several Steps and the Tax Consequences of the Last Step Determined Independently of the Whole.

The final question presented, and the most important one as far as the petitioner is concerned, is whether the sale of the collateral bonds in 1944 must be isolated from the transaction of which it was a part and treated as the issuance of bonds at a discount.

The answer to that question depends upon whether an integrated business transaction may be broken down into its various steps (i.e. the borrowing of money in 1932; the deposit of collateral bonds as security, and after default, the sale of the collateral security in 1944), and the tax consequences of the last step determined independently of the transaction as a whole.

The financial detriment which accrued unconditionally upon the sale of the collateral bonds in 1944 must be regarded as a cost or expense or loss proximately related to and growing out of the 1932 borrowing transaction. Any other view is not in accord with reality. In the instant case, the bond discount amortization rule is inapplicable, and the general rule, i.e. the "all events" rule reaffirmed in *United States v. Consolidated Edison Co.*, 1961, 366 U.S. 380 384, 81 S. Ct. 1326, 1329, requires the deduction thereof in 1944 when it unconditionally accrued.

To isolate the last step, namely, the sale of the bonds, and to treat such sale as separate corporate financing arrangement is unreal. No company would voluntarily

issue $5,601,811.25 of its own obligations for a net amount of $1,498,176 under conditions such that *the entire sum was due and payable forthwith* (see pp. 29 and 35 of C.C.A. Appendix. See also Section 10 of Def. Exhibit 8, at p. 149).

The substance of the transaction was a sale by the lender, of collateral security and not the issuance by the maker of bonds at a discount. It is only by separating the 1932 borrowing transaction into its various steps that the last step could be treated as an issue of bonds at a discount.

The substance of an integrated transaction and the tax consequences thereof must be determined with reference to the entire transaction and not by "atomizing" or separating the several steps and determining the tax consequences of a single step independently of the whole.

Commissioner v. *Bagley & Sewall Co.*, 2 Cir. 1955, 221 F. 2d 944, 946

Commissioner v. *Ashland Oil & Refining Co.*, 6 Cir. 1938, 99 F. 2d 588, 591, 592, cert. den. 306 U.S. 661

Kimbell-Diamond Milling Co. v. *Commissioner*, 14 T.C. 74, 80, affd. per curiam, 5 Cir. 1951, 187 F. 2d 718, cert. den. 342 U.S. 827

Hirsch v. *Commissioner*, 7 Cir. 1940, 115 F. 2d 656, 658.

The decision of the Court below is in conflict with the rational of each of the above cited decisions.

The conclusion that the entire loss accrued immediately upon the sale of the collateral in 1944 is inescapable. The bonds contained, *inter alia*, the following language: "*In case . . . any order of adjudication in bankruptcy against the Company, or upon the appointment of a receiver or receivers for the Company or the trust estate, or any part thereof, in any proceed-*

ing not brought by the Trustees, the principal of all bonds hereby secured, if not previously due, shall thereupon become due and payable, anything in said bonds or in this Mortgage to the contrary notwithstanding." (see paragraph XVI of Complaint, C.C.A. Appendix p. 13. See also Def. Exhibit 8, Sec. 10 at p. 149).

As early as September 30, 1932, a creditor's bill in equity was filed in the United States District Court for the Northern District of Illinois, Eastern Division, by American Brake Shoe and Foundry Company on behalf of itself and other creditors. Moreover, on December 16, 1937, the City National Bank and Trust Company of Chicago and Arthur T. Leonard as successor Trustees filed their bill to foreclose the first and refunding mortgage (see p. 5, Exhibit C, Trustees' Report and paragraph 1 of Stipulation of Facts, C.C.A. Appendix, p. 21).

Thus, within the same year as occurred the 1932 borrowing transaction, the bonds deposited as collateral to secure this borrowing became due and payable by virtue of the acceleration provision and the filing of the creditor's bill. Accordingly, in 1944, when these bonds were sold by the holders of notes, the purchasers of these bonds took an instrument which was, according to its tenor, payable forthwith. In other words, the purchasers took a *demand instrument*.

Even if it can be said that the sale of the collateral bonds by the lenders is a separate transaction and, in determining its Federal tax consequences, it must be isolated from the 1932 borrowing transaction of which it formed a part and that the excess of the maturity value of the bonds over their proceeds and the aggregate of the matured interest coupons represented "bond discount", there is no period over which the discount may be amortized. The coupons were due

and payable *and the principal amount of the bonds were then due and payable.*

To require that this amount be amortized over the period intervening from the date of the sale of the bonds to the dates in 1955 and 1956 upon which they became due according to their original tenor, would be, to use the words of the Court of Appeals, "to ignore practical realities."

The sale of the collateral bonds in 1944 directly and proximately resulted from a normal business transaction entered into in 1932 for the purpose of corporate business financing. Whether the resulting financial detriment be characterized as a loss or as an ordinary and necessary business expense or in part as interest is immaterial. It was one or the other. The deduction is allowable when it accrued unconditionally in 1944.

The decision of the courts below is in conflict with the "all events" test of accrual reaffirmed in *United States* v. *Consolidated Edison Co., supra.*

CONCLUSION

All of the foregoing issues arise out of the same transaction, namely, the sale of the collateral bonds in 1944. They involve tax accounting principles of importance to all accrual basis taxpayers. The decision of the court below is in conflict with the decisions of this Court and the Courts of Appeals cited above. These conflicts should be resolved. The petition should be granted.

Respectfully submitted.

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